DEPARTMENT OF STATE REVENUE

02-20100665.LOF

Letter of Findings: 02-20100665
Corporate Income Tax
For the Years 2002 through 2006

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ISSUE

I. Combined Return Requirement – Corporate Income Tax.

Authority: IC § 6-3-2-2(l); IC § 6-3-2-2(m); IC § 6-3-2-2(p); IC § 6-8.1-5-1(c); 45 IAC 3.1-1-62; Treas. Reg. § 1.482-1(b)(1); Playing 'the Price Is Right' With State Transfer Pricing Studies, State Tax Notes, Jan. 3, 2011.

Taxpayer argues that the Department of Revenue was without authority in its decision requiring Taxpayer's unitary group to file a combined Indiana income tax return and that the decision to do so was unjustified.

II. Ten-Percent Negligence Penalty.

Authority: IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(a)(4); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c); Letter of Findings 02-20050175 (February 24, 2006).

Taxpayer states that it is entitled to abatement of the ten-percent negligence penalty because its original returns were based upon a legitimate and justifiable interpretation of Indiana tax law.

III. Underpayment Penalty.

Authority: IC § 6-3-4-4.1(d).

Taxpayer maintains that the imposition of the ten-percent underpayment penalty should be abated because imposition of this penalty is inconsistent with the statutory scheme of providing Indiana taxpayers with a "safe harbor."

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of manufacturing and selling products. Taxpayer sells these products to Indiana customers. Taxpayer has Indiana branch offices which provide repair and maintenance services for its products.

During the period under audit, Taxpayer filed federal consolidated returns which reported approximately $563,000,000 in federal taxable income.

During the period under audit, three members of the federal consolidated group filed separate Indiana returns reporting a total loss of approximately $21,000,000.

The Department of Revenue conducted an audit review of Taxpayer's income tax returns and business records.

The audit report concluded that, "The taxpayer has utilized subsidiaries and intercompany transactions to shield all of the consolidated taxable income from apportionment to the state of Indiana." Based on that conclusion, the Department required that Taxpayer file a "combined return" to report the income of Taxpayer's "unitary group."

The decision resulted in the assessment of additional Indiana income tax. Taxpayer objected to the audit's conclusions, objected to the additional assessment, and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Combined Return Requirement – Corporate Income Tax.

DISCUSSION

Taxpayer argues that the Department did not have statutory authority requiring it to file a combined return and that the decision requiring Taxpayer and its associated unitary group to do so was unjustified.

The audit arrived at its decision requiring a "combined filing" based in part on authority found at IC § 6-3-2-2(l). IC § 6-3-2-2(l) states in relevant part:

> (l) If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
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> (1) separate accounting;
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> (2) for a taxable year beginning before January l, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
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> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
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> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. (m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate

the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

IC § 6-3-2-2(m) authorizes the department to resort to alternative methods of reporting income:

In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

IC § 6-3-2-2(p) states that requiring a taxpayer to file a combined return is warranted only if necessary to "fairly" reflect the taxpayer's Indiana income.

Notwithstanding subsections (l) and (m), the department may not require that income, deductions, and credits attributable to a taxpayer and another entity not described in subsection (o)(1) or (o)(2) be reported in a combined income tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (l) and (m).

Taxpayer points to 45 IAC 3.1-1-62 in order to emphasize its contention that requiring Taxpayer to file a "combined return" is an out-of-the-ordinary if not extreme measure. The Department's regulation states:

All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37–45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

As a threshold issue, it is the Taxpayer's responsibility to establish that the tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

A. Statutory Authority:

The first issue Taxpayer raised is whether or not the Department has the authority to require Taxpayer to file a "combined return." On this question, the answer is clear. Plainly the IC § 6-3-2-2(l) and (m) provides the authority for the Department to require that members of a "unitary group" ("businesses owned or controlled directly or indirectly by the same interests") file a combined return.

B. Justification:

The second issue is whether or not the Department's audit was justified in requiring members of Taxpayer's unitary group to file the combined return. Taxpayer correctly points out the Department may resort to such a remedy only when Taxpayer's previous reporting methodology "does not fairly attribute income to [Indiana] or other states" and that such instances will only occur in "limited and unusual circumstances." IAC 3.1-1-62.

The audit report concluded, "The proper result is to include in a combined return all legally separate but functionally interdependent members. The income of the unitary group is earned by all of the members."

However, before doing so the audit report indicates that "[a]lternative methods [were] considered in order to fairly reflect the income derived from sources in Indiana." The audit's log of activities indicates that the issue was raised with Taxpayer as follows: "[Auditor] prepared a letter to taxpayer which states that [Taxpayer] and its affiliates comprise a unitary group. The returns as filed are distorted due to intercompany transactions and arrangements... Requested that the taxpayer advise a recommendation to overcome the distortion." Taxpayer declined to make any such recommendation.

Nonetheless, Taxpayer suggests that the auditor was incorrectly placing the burden of proof on Taxpayer to provide an alternative to Taxpayer's original filing or to provide an alternative to the combined filing. The Department must disagree that the audit improperly shifted the "burden" of proof to Taxpayer during the course of the audit. Quite reasonably, the Department's audit raised what it preliminary regarded as the "distortion" issue and asked that Taxpayer respond or provide alternatives before resorting to "combined reporting." It would appear that in doing so the audit did no more and no less than what was required of it under IC § 6-3-2-2(p) which provides that the Department may not require combined reporting "unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department...."

C. Transfer Pricing Study:

In what appears to be Taxpayer's primary objection to the Department's decision requiring "combined reporting," Taxpayer points to its "transfer pricing study" prepared by a major accounting firm. Taxpayer indicates that the legitimacy of the transfer pricing study – and its conclusion that the related parties' internal pricing

structure represented "arms'-length" transaction – is supported by substantial authority. For example, Taxpayer points to Treas. Reg. § 1.482-1(b)(1) which states that "a controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's-length result)."

However, what is left unaddressed is to what extent the "transfer pricing study" – prepared to address concerns raised under I.R.C. § 482 – is dispositive of the question of whether or not – for state income tax purposes – Taxpayer's pricing structure does or does not accurately reflect Indiana source income. Taxpayer's transfer pricing study states as follows:

> This report is limited to issues concerning compliance with IRC section 482 for the specified transactions. Additional issues may exist that could affect the State or Federal tax treatment of the transaction(s) that are the subject of this report and the report does not consider or provide a conclusion with respect to any additional issues.

The Department has no quarrel whatsoever with issues relating to I.R.C. § 482 and whether or not the transfer pricing study properly or accurately addressed federal income tax issues. Issues relating to federal questions are best addressed by Taxpayer and the federal authorities responsible for enforcing the Internal Revenue Code. However, when Taxpayer's unitary group reports federal taxable income in excess of one-half billion dollars and when the members of the Indiana consolidated group report a loss of approximately 21 million dollars, it is not unexpected or unreasonable to question whether or not the unitary group's Indiana source income was being accurately and fairly reported for Indiana income tax purposes. The disparity between the income reported on the federal consolidated returns and the losses reported on the Indiana consolidated return would have had no effect on the federal liability. As noted in Playing 'the Price Is Right' With State Transfer Pricing Studies, State Tax Notes, Jan. 3, 2011, at 23, 27, "The reasons for requiring transfer pricing studies in international tax controversies are inappropriate in the multistate tax context." However, it is indisputable that this disparity – and the perceived "distortion" – would and did have an effect on the Indiana tax liability.

D. Alternatives:

Taxpayer argues that the audit's decision requiring the unitary group to file a combined return was incorrect because there is a more appropriate and less onerous alternative. Taxpayer states that "the Auditor may increase such income only to the extent that such payments made by [Taxpayer] and the subsidiaries exceed an arm's-length payment, not force [Taxpayer] to file a combined return." Taxpayer is correct to the extent – as mentioned previously – IC § 6-3-2-2(p) requires that the Department must use its "other powers" before requiring that any taxpayer file a combined return.

Taxpayer somewhat belatedly offers an alternative having an effect presumably midway between filing separate returns and filing a combined return which would in turn more accurately reflect the unitary group's Indiana source income. However an administrative hearing is not the appropriate forum in which to second-guess the auditor, to conduct a supplemental audit of Taxpayer's business records, or reexamine the complexities of Taxpayer's internal financial transactions. It is not unreasonable to point out that the audit specifically asked Taxpayer to offer such an alternative well into the course of the audit and Taxpayer declined to do so. As stated in the audit report, "The taxpayer has declined to suggest an alternative to its filing method to fairly reflect the income of the unitary business."

E. Constitutionality:

Taxpayer argues that the decision requiring it to file a combined return is unconstitutional because it violates the Due Process Clause and Commerce Clause. Taxpayer concludes that the combined filing requirement "results in taxation of income with no substantial relationship to Indiana, leads to grossly distorted income, and subjects [the unitary group] to multiple taxation or the risk of multiple taxation of the same income by more than one state."

Taxpayer has produced no evidence that the Department's decision requiring the unitary group to file a combined return results in taxation of the same apportioned Indiana source income by more than one state. Taxpayer's argument to that effect is entirely speculative.

Taxpayer's argument that the Department's decision – on its face – violates the United States Constitution is equally speculative and unsupported.

FINDING

Taxpayer's protest is respectfully denied.

II. Ten-Percent Negligence Penalty.

DISCUSSION

Taxpayer believes that it is entitled to abatement of the ten-percent negligence penalty because "it had a reasonable cause for its position." Taxpayer continues stating that its positions were "based upon bona fide interpretations of Indiana taxing statutes, Indiana case law, and Department policy...." Taxpayer states that its positions could not be ascribed to "willful neglect or intentional disregard of the law..." and that its Indiana taxes "were reported in good faith and with a reasonable basis."

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(4) requires a ten-percent penalty if the taxpayer "fails to pay the full

amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to... pay the full amount of tax shown on the person's return... or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty."

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed...."

Under IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment – including the negligence penalty – is presumptively valid.

The Department believes that taxpayer erred in determining state income tax liability but also is unable to agree that the penalty was unwarranted. The issues raised in this particular audit were addressed in a previous audit for the years 1998 through 2001. The identical issue – whether or not Taxpayer's unitary group should be required to file a combined return – was addressed in that previous audit. The results of the earlier audit were the same, and the subsequent protest resulted in an administrative decision agreeing with the earlier audit holding that "the combination of legally separate but functionally interdependent identities – a unitary return – is the appropriate remedy." Letter of Findings 02-20050175 (February 24, 2006).

FINDING

Taxpayer's protest is respectfully denied.

III. Underpayment Penalty.

DISCUSSION

Taxpayer objects to the imposition of the ten-percent "underpayment penalty." The penalty is authorized under IC § 6-3-4-4.1(d);

> (d) The penalty prescribed by IC 6-8.1-10-2.1(b) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:
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> (1) the annualized income installment calculated under subsection (c); or
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> (2) twenty-five percent (25[percent]) of the final tax liability for the taxpayer's previous taxable year.
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> In addition, the penalty as to any underpayment of tax on an estimated return shall only be assessed on the difference between the actual amount paid by the corporation on such estimated return and twenty-five percent (25[percent]) of the corporation's final adjusted gross income tax liability for such taxable year.

In particular, Taxpayer states imposing the "underpayment" penalty "determined after an audit rather than that reported on the original return is directly contrary to the legislative purpose in providing a safe harbor for avoidance of the penalty...." Taxpayer asserts that because the Department has already imposed the ten-percent negligence penalty, "it would be illogical to impose a second 10[percent] penalty on all deficiencies irrespective of whether they were due to negligence."

Taxpayer concludes that, "The logical conclusion is that the Legislature intended the estimated tax penalty to apply only when the taxpayer fails to make adequate estimated payments relative to the liability self-reported on its return."

The Department takes no position on whether or not the underpayment penalty may or may not be imposed in conjunction with the "negligence" penalty. The Department takes no position on whether the statute allows for a good faith "safe harbor" exception. However, after reviewing the facts and circumstances, the Department agrees that the ten-percent underpayment penalty should be abated.

FINDING

Taxpayer's protest is sustained.

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